



Kristina Hooper
Chief Global Market Strategist



Responsive policymakers.

My key takeaway from last week is that policymakers continue to be both sensitive to and responsive to signs of problems.

Dovish rate hikes.

In my opinion, the Federal Reserve and the Bank of England got it right with their 25 basis point rate hikes.

Blessing in disguise?

The banking mini-crisis may help prevent central bankers from overtightening and sending economies into a broad recession.

Policymakers offer reassurance as markets face a crisis of confidence

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Last week brought us dovish rate hikes from two major central banks, some important statements from policymakers as they sought to contain the difficulties in the banking sector, and, of course, a roller coaster ride for markets. What does all of this add up to? I, for one, believe that while the pathway to a soft landing for the economy may have narrowed, the banking mini-crisis may turn out to be a blessing in disguise, ending rate hikes sooner and preventing central bankers from overtightening and sending economies into a broad recession.

Let's examine what we learned last week.

Monday and Tuesday: Policymakers reassure investors and depositors

The week began with news about the shotgun wedding between Credit Suisse and UBS, with the Swiss National Bank serving as matchmaker. Markets were rightly rattled by the surprise decision to place equity holders higher in the capital hierarchy than the holders of AT1 bonds. However, policymakers in the UK and European Union (EU) were quick to draw a clear distinction between their banks and Swiss banks; they emphasized that they would honor the traditional capital structure hierarchy, with equity holders being the first to experience losses in the event of a failure.

On Tuesday, US Treasury Secretary Janet Yellen struck a reassuring tone as she told the American Bankers Association that the US banking system is strong. She also shared that she and other government officials are considering ways they can insure all deposits at all banks in the United States. This helped boost confidence in markets. (But, as we'll see below, this wasn't her last word on the issue last week.)

Wednesday: A dovish hike from the US Federal Reserve

Then came the Federal Open Market Committee (FOMC) meeting on Wednesday. As most expected, the Federal Reserve (Fed) hiked rates by 25 basis points, which I believe was appropriate. As I said in my blog last week, the middle of the road would be the best approach, in my view. Not hiking rates or cutting rates would have indicated that the Fed thinks we are in a crisis. Hiking rates 50 basis points would have been overkill given the recent banking problems, which were largely caused by aggressive rate hikes over the past year. Hiking rates 25 basis points shows that the Fed is in "business as usual" mode and that fighting inflation is still important – and the Fed has other tools it can use to manage any issues that arise.

In short, this was a dovish rate hike. The wording in the FOMC statement related to guidance changed; the "ongoing increases" language was removed. And during his press conference, Fed Chair Jay Powell admitted that the March rate hike could be the last hike for the time being. There was also some confidence created by the Fed's unanimous decision on the rate hike. Not surprisingly, the dot plot

showed no expectation of rate cuts this year, as the Fed continues to believe the economy is on solid footing. Powell underscored that in his press conference when he said that rate cuts are not in the Fed's base case for 2023. The message that came through is that the Fed is still data dependent – but it needs to tread more carefully. So simply put, in my opinion, the Fed got it right this time.

However, the FOMC decision and press conference were eclipsed by statements from the Treasury Secretary on Wednesday afternoon. Yellen seemed to backtrack on comments she made the previous day, now saying that she wasn't working on ways to provide broad guarantees for deposits at banks. It seems she was being sensitive to the reality that legislation would be needed to provide that kind of broad guarantee, although the US government implied that guarantee when it provided a backstop for the regional banks and created the new bank credit facility earlier in March. However, her words threw cold water on market sentiment and sent stocks down. (Again, as we'll see below, this wasn't the last time Yellen weighed in on the issue last week.)

Thursday: The Bank of England strikes an optimistic tone

Thursday brought the Bank of England (BoE) meeting. Another rate hike was announced, but only a 25 basis point increase (with two members favoring no increase). The BoE's guidance changed, suggesting the cycle of 11 consecutive rate hikes was coming to an end. The BoE struck an optimistic tone, expecting wage pressures to ease and inflation to come down. I thought this was the appropriate decision. As with the Fed, hiking rates modestly but changing guidance acknowledges that this is business as usual for the BoE and that fighting inflation is still important, although there is a need to be more cautious.

Thursday also saw Yellen attempt to bolster confidence after her statements on Wednesday. She emphasized that "...we have used important tools to act quickly to prevent contagion. And they are tools we could use again. The strong actions we have taken ensure that Americans' deposits are safe. Certainly, we would be prepared to take additional actions if warranted."¹ That contributed to a better mood for markets at the end of the week.

Key takeaways

My key takeaway from last week is that policymakers continue to be sensitive to and responsive to signs of problems.

- UK and EU officials were quick to differentiate their treatment of AT1 bonds from Swiss AT1 bonds in response to concerns about how Swiss authorities were treating them.
- Yellen was quick to clarify/alter her comments about widespread deposit guarantees when she realized that statements she made on Wednesday had undermined confidence in the US banking system.
- Monetary policymakers are still focused on their "day job" – fighting inflation – but understand they need to be more careful and sensitive in tightening going forward. We heard as much this weekend from Bundesbank President Joachim Nagel. He reiterated that the European Central Bank is still fighting inflation but is also on alert, standing ready to respond to any potential financial stress.

Policymakers aren't tone deaf and they understand the important role they play in building and maintaining confidence in the financial system. That, for me, is a very important takeaway.

Where do we go from here?

Economists and strategists are hypothesizing on the possible scenarios we might see from here. As I mentioned at the outset of this column, I, for one, believe that while the pathway to a soft landing to the economy may have narrowed, the banking mini-crisis we have seen may turn out to be a blessing in disguise, ending rate hikes sooner rather than later and preventing central bankers from overtightening and sending economies into a broad recession. Yes, I expect credit conditions will tighten and exacerbate a slowdown, but I'm optimistic they won't tighten dramatically — certainly enough to convince central banks that they are doing the central banks' work for them but not enough to cause a broad, deep recession.

At the end of the day, monetary policy is all about financial conditions. Tighter policy means tightening the flow of capital, credit, and equity that flows into business and consumer spending. That typically results in financial volatility and shocks. And these shocks can cause a severe tightening in financial conditions that causes rapid reductions in spending, employment, growth, and inflation. That's why rate-setting processes often have an earlier and faster easing cycle than the tightening process.

But it's important to bear in mind that not every series of financial shocks, or even crises like the bank runs of late, represents a systemic crisis like 2008. In fact, very few represent a systemic crisis: There were only three periods between 1934 and 2022 when rate rises were followed by systemic financial crises in the United States.²

Even so, the credit tightening by regional banks is likely to reduce the flow of funds to commercial real estate and construction, which could cause job growth to slow. The result could be a recession but, if so, I would expect it to be shallow and short. With the Fed prepared to halt tightening and history showing that it often eases rapidly — and with signs that these are contained financial issues, there are still very good reasons to expect any downturn to be relatively moderate, unlike the 2008 downturn.

And the end of tightening would likely result in improved market conditions, especially lower volatility. I would expect that, once we achieve two conditions — the Fed officially hits the pause button and bank stresses ease — markets are likely to start to discount an economic recovery. Until then, I would anticipate investors will benefit from more defensive positioning.

Looking ahead, I will be focused on eurozone inflation data, China Purchasing Managers Index data, and the US Personal Consumption Expenditures reading, given that is the Fed's preferred gauge of inflation. I'll also be watching University of Michigan Inflation Expectations, which I believe are an important part of the Fed's calculus. Most importantly, I will be looking for policymakers to continue to respond quickly and effectively to any issues that arise. At the end of the day, this is largely a crisis of confidence, in my view, so the fate of financial markets is at least partially in the hands of policymakers.

With contributions from Arnab Das and Andras Vig.

Notes

¹Source: US Department of the Treasury, March 23, 2023

²Source: Federal Deposit Insurance Corporation, Global Financial Data, Refinitiv Datastream, Invesco

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

Contagion is the likelihood that significant economic changes in one country will spread to other countries.

AT1 debt securities form part of the capital that banks issue to meet their regulatory requirements. They are designed to have loss absorbing features to provide a buffer against bank failure.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The Deutsche Bundesbank is the central bank of the Federal Republic of Germany.

Personal Consumption Expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

The opinions referenced above are those of the author as of March 27, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.